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IN THE SUPREME COURT
OF THE STATE OF WASHINGTON

MUTUAL OF ENUMCLAW INSURANCE COMPANY
Respondent/Cross-Petitioner,

v.

DAN PAULSON CONSTRUCTION, INC., a Washington corporation,
KAREN and JOSEPH MARTINELLI, and the marital community
composed thereof,

Petitioners/Cross-Respondents.

**AMICUS CURIAE BRIEF ON BEHALF OF BUILDING INDUSTRY
ASSOCIATION OF WASHINGTON**

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I. INTRODUCTION

This case presents a clear example of an insurer failing to abide by the legal duties owed to its policyholder. In the case at hand, Dan Paulson Construction, Inc. (Paulson) turned to its insurance company when a claim was filed against it for alleged construction defects. Paulson's insurer, Mutual of Enumclaw (MOE), elected to defend Paulson under a common reservation of rights defense. Paulson then entered into settlement negotiations with the homeowners. MOE failed to honor its legal duties of good faith and fair dealing during the arbitration proceedings between Paulson and the homeowners when it unnecessarily interfered with the settlement negotiations by issuing a subpoena and interrogatories and by engaging in ex parte communication with the arbitrator.

As a result of MOE's bad faith acts, this Court should once again explain the legal duties owed to policyholders by insurers once a reservation of rights defense is undertaken.

II. ISSUE OF CONCERN TO *AMICUS CURIAE*

1. Did Mutual of Enumclaw disregard its legal duties of good faith and fair dealing, and violate the "elevated level of trust" required between insurer and insured, compromising the insurance

relationship and subjecting Paulson to unnecessary exposure to liability?

III. IDENTITY AND INTEREST OF *AMICUS CURIAE* BUILDING INDUSTRY ASSOCIATION OF WASHINGTON

The Building Industry Association of Washington (BIAW) is the largest trade association in the state with over 12,600 members, employing over 350,000 Washingtonians. In order to be registered in Washington state, a builder must show proof of liability insurance. Therefore, BIAW's members are directly impacted by any decision or policy change that affects their relationship with insurers.

BIAW, as an association representing numerous home builders who will be affected by this Court's decision, brings a unique perspective of those who are directly impacted by the lower court's decision. Therefore, BIAW believes an *amicus curiae* brief can be of substantial assistance to this Court.

IV. STATEMENT OF THE CASE

Amicus BIAW adopts and incorporates the statement of facts as set forth in the Respondents'/Cross-Appellants' brief for the Court of Appeals.

V. ARGUMENT

A. MOE's Actions Do Not Reach the Elevated Level of Trust Required Between Insurer and Policyholder

Washington courts have defined the insurer's duty and "expanded the remedies available to a policyholder who is denied a defense or whose defense is improperly handled by the insurer." Will F. Cronin & Colleen A. Christensen, *Litigating the Duty to Defend: The Policyholder's Perspective*, 28 Gonz. L. Rev. 641 (1992/93). Washington law sets forth several qualities that define the relationship between the insured and insurer. Specifically, the insurer must act in good faith, under a duty of fair dealing and set its monetary interests on equal footing as its insured's interests. *See Safeco Ins. Co. v. Butler*, 118 Wash.2d 383 (1992); *Tank v. State Farm Fire & Cas. Co.*, 105 Wash.2d 381 (1986), *Industrial Indem. Co. of the N.W. v. Kallevig*, 114 Wash.2d 907 (1990), *Smith v. Safeco Ins. Co.*, 150 Wash.2d 478 (2003). These obligations exist regardless of whether there is a conflict of interest or lack of clear liability coverage. *Tank*, 105 Wash.2d at 388 (holding that the insurer's obligation to the policyholder under a reservation of rights defense has four components, including the provision of competent counsel for its policyholder and a "thorough investigation" of the cause of action).

As this Court noted in *Tank*:

The source [of the good faith duty] is the fiduciary relationship existing between the insurer and insured. Such a relationship exists not only as a result of the contract between the insurer and insured, but because of the high stakes involved for both parties to an insurance contract and the *elevated level of trust underlying insured's dependence on their insurers* .. . It implies 'a broad obligation of fair dealing,' and a responsibility to give 'equal consideration' to the policyholder's interests. (emphasis added)

Tank, 105 Wash.2d at 385.

Specifically, the reservation of rights defense gives rise to an enhanced duty because of the potential conflicts of interest inherent in the situation. *Tank*, 105 Wash.2d at 383. Where an insurer agrees to a reservation of rights defense, it "must fulfill an enhanced obligation to its policyholder as part of its duty of good faith." *Tank*, 105 Wash.2d at 387. This Court has noted that the duty of good faith may be breached by conduct that does not reach the level of intentional bad faith. *Kallevig*, 114 Wash.2d at 917.

MOE's election to assert a reservation of rights defense in this case presented the same potential conflicts of interest contemplated by this court in *Tank* and *Butler*, and, therefore, MOE was bound to act according to this "elevated level of trust."

B. MOE did not fulfill its duties to avoid any "unreasonable, frivolous or unfounded" interference and to keep the insured "fully informed."

Instead of conducting timely and prompt communication regarding developments in the claim process, counsel for MOE in this case chose to improperly and unnecessarily interfere with the settlement negotiations by contacting the arbitrator with an ex parte letter. Even the Court of Appeals concluded that the “ex parte cover letters were improper.” *Mutual of Enumclaw Ins. Co. v. Dan Paulson Const. Inc.*, 132 Wash.App. 803, 813 (2006). These actions fit squarely within this Court’s definition of “bad faith” as “unreasonable, frivolous or unfounded” conduct affecting a major benefit of the insurance policy. *Smith*, 150 Wash.2d at 485.

Further, counsel for MOE did not provide adequate notice or communication to Mr. Paulson.. As part of the heightened duty owed to the insured, the insurer is obligated to communicate with the insured. *See* Matthew L. Sweeney, *Tank v State Farm: Conducting a Reservation of Rights Defense in Washington*, 11 U. Puget Sound L. Rev. 139, 156 (1987). (“As the fiduciary of the policyholder, the insurer is duty-bound to keep the policyholder fully informed, whether a conflict of interest exists or not. In a conflict situation, it is not so much the insurer’s duty to provide information that increases as it is the policyholder’s need for this information.”).

In this case, Paulson and the homeowners didn’t learn of MOE’s ex parte communication with the Arbitrator until the Arbitrator told them

of the letter just prior to the commencement of the arbitration. In addition, counsel received a copy of the subpoena issued to the Arbitrator just four days before the start of the arbitration trial.

These arguments do not suggest that insurers such as MOE to “stand by and do nothing,” as the Court of Appeals stated in *Paulson*, 132 Wash.App.at 813. Although the insurer’s counsel may be involved in the arbitration proceedings, the duties of the insurer necessitate that the insured party should not be harmed by its own insurer. In this case, MOE had other options for properly intervening in the settlement process.

This Court should reconfirm that these are the exact type of actions that constitute bad faith and thus violate the legal duties owed to policyholders once the insurer undertakes a reservation of rights defense.

C. Approving MOE’s Inappropriate and Unnecessary Actions Will Discourage Further Settlements and Lead to Increased Exposure to Liability for Builders.

In order to register as a contractor in Washington state, the registrant must show proof of liability insurance (unless the contractor files an assigned account in the amount of \$350,000). *See* RCW 18.27.050 (“At the time of registration and subsequent re-registration, the applicant shall furnish insurance or financial responsibility in the form of an assigned account . . .”). Other than satisfying the prerequisite to do business in Washington, contractors acquire insurance policies to preserve

their own financial well-being in the event that the contractor is exposed to liability.

At a time when affordable housing is in great demand and litigation continues to threaten housing costs, the home building industry depends on affordable and available liability insurance. Just a few years ago, Washington was in the midst of a crisis in the contractor liability insurance market. The lack of insurance forced many contractors to go out of business, lose contracts, or worse: drive some builders underground as unregistered contractors. To remedy this problem, the legislature passed legislation in 2002 that curbed litigation by preventing a lawsuit until the builder is given the opportunity to fix or pay for the defect. *See* RCW 64.50.020. One year later, another law was passed aimed at easing the existing burden on the insurance market. That piece of legislation allows for affirmative defenses in construction defect cases. *See* RCW 4.16.326. Both of these pieces of legislation helped ease liability for builders. The lower court's decision threatens those gains by exposing builders to greater liability.

Home builders rely on their insurer's promise to protect against the potential for ruinous economic loss. The kind of unnecessary disruption in arbitration proceedings that occurred in this case could affect similarly situated builders. This in turn could lead to greater uncertainty for

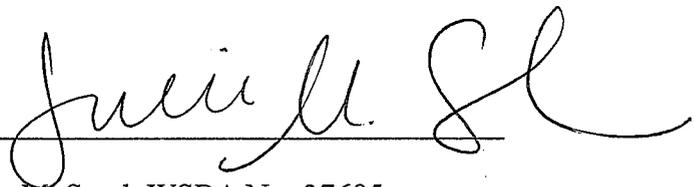
builders when it comes to liability and increased risk of additional litigation expense. Requiring insurers to meet the legal duties owed to their policyholders is paramount to the building industry. Approving MOE's actions in this case by upholding the Court of Appeal's decision would take away the very foundation on which this relationship is built.

VI. CONCLUSION

Based on the foregoing, *amicus* BIAW requests this Court reverse the ruling of the Court of Appeals, Division I and uphold the trial court's ruling that MOE is estopped from denying coverage in this case.

RESPECTFULLY SUBMITTED this 15th day of May, 2007.

By



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